United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-6189

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

v.

BAUSCH & LOMB INCORPORATED and
DANIEL G. SCHUMAN,

Defendants-Appellees.

Appeal from the United States District Court
for the Southern District of New York

REPLY BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLANT

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CITATIONS

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Preliminary Statement

The Securities and Exchange Commission, the appellant herein, submits this brief in reply to those few points raised in the defendants' answering brief which warrant any further response. 1/ At the outset, however, we feel constrained to note that the defendants' characterizations of the statement of facts and arguments made in the Commission's brief are unfair and inaccurate,

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1/ "SEC Br. __ " refers to the Commission's opening brief and "BOL Br. __" refers to the defendants' answering brief. JA __" and "Ex. __" refer respectively to the pages of the joint appendix and the volumes of exhibits which were filed with this Court.

and they fly in the face of the specific contents of the Commission's brief. 2/ Unfortunately, however, much of the caustic contained in the defendants brief is free floating, unsupported and, hence, is difficult to respond to meaningfully. 3/ We have, where possible, alluded to these attacks in the body of this reply. In light of the defendants' comments, however, we again have reviewed both the record and the references to the record set forth in our opening brief. We stand by the facts as we have accurately stated them.

2/ See, for example, BOL Br. 16-17, where it is stated that "[t]he most flagrant omission from the Commission's account" is the "silence" about one analyst, Sanders, who also received inside information from Mr. Schuman. The defendants argue that "the Commission tries to sweep * * * under the rug" the fact that Sanders bought, rather than sold, BOL stock in response to Mr. Schuman's improper disclosures. But, the Commission's brief did state (SEC Br. 82) that, "[u]nlike his fellows, Mr. Sanders bought BOL stock," and noted that the inside information divulged by Mr. Schuman was of such a nature that it could have been perceived differently by persons with short term goals from those with long term goals.

Similarly, the defendants' assert (BOL Br. 33) that "the Commission ignores the fact" that Reuters had reported that a Senate panel had started an investigation which tended to dampen investor sentiment for BOL stock. But, the Commission's brief stated (SEC Br. 81 n. 128): "The reports of a possible Senate investigation (JA 164) had been out since March 2 and 3 (Ex 390-391) and would have been stale by March 16.

3/ See, for example, BOL Br. 4 ("taking great liberties with the record;" "The picture which the Commission would paint is wildly distorted"); 14 ("shallow and disingenuous attempt;" "new assertions are seriously misleading").

The defendants suggest (BOL Br. 4) that the Commission seeks in this Court to "advance theories never urged upon the trial court," but they neither articulate the new theories which they perceive as now being advanced by the Commission, nor do they point to specific passages in our opening brief in order to refer this Court, as well as Commission counsel, to such theories.

I. THE DISTRICT COURT'S DETERMINATION REGARDING THE PROPRIETY OF INJUNCTIVE RELIEF WAS TAINTED BY AN ERRONEOUS UNDERSTANDING OF THE APPLICABLE LAW. ACCORDINGLY, THE DETERMINATION TO DENY AN INJUNCTION SHOULD BE REVERSED.

The gravamen of the Commission's appeal in this action is relatively simple—the lower court seriously misconstrued the law with respect to the substantive violations charged, 4/ and it also misperceived the applicable standards for the grant of injunctive relief, 5/ in derogation of this Court's numerous holdings to

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4/ In essence, we argued that the district court erred, inter alia,

- in holding that scienter is a necessary element of a Commission action seeking equitable relief under Section 10(b) of the Securities Exchange Act and Rule 10b-5;
- by applying an erroneous standard of materiality;
- in holding that the Commission should promulgate administrative regulations regarding the scope of communications with securities analysts rather than exercise its statutory discretion to proceed by the institution of a civil injunctive action; and
- in announcing that the Commission, through the exercise of non-existent "administrative" powers, could accomplish the same result sought to be achieved by the equitable relief requested in the form of written procedures.

5/ Despite the contentions of the defendants to the contrary (BOL Br. 76), this Court has never held, as the court below did (JA 175), that an injunction is an "extraordinary" remedy, to be granted in "extraordinary circumstances." To the contrary, this Court, and other courts, have held that the Commission is presumptively entitled to a statutory injunction when it has proven a violation of law, and that a reasonable likelihood of future violation exists. In this regard, it bears emphasis to call to mind the statement of then District Judge Irving R. Kaufman in Securities and Exchange Commission v. Graye, 156 F. Supp. 544, 547 (S.D. N.Y., 1957) (citations omitted):

> "I fail to see any injury resulting to defendant by the granting of this injunction. * * * The injunction does not seek to put defendant out of business. It seeks only to restrain him from doing business while he is in violation of the S.E.C. rules. It does not seek to harm defendant, but rather to protect the public. Compliance will mean continuation."

the contrary. The Commission urges that the defendants here violated the antifraud provisions of the federal securities laws, and that, absent an injunction, there is a reasonable likelihood of future violations by them. To that end, the Commission argued in its opening brief (SEC Br. 26, 89) that this case should be remanded to the district court to consider whether, in the light of proper legal standards, an injunction should issue. Alternatively, the Commission argued (SEC Br. 89) that this Court should direct the granting of an injunction and other equitable relief requested by the Commission on the existing state of the record. Inexplicably, however, the defendants incorrectly assert (BOL Br. 39) that the finding of the district court — that there was no reasonable likelihood of future violations — "is not here challenged by the Commission." Indeed, it is.

Instead of confronting the Commission's arguments in this regard directly, the defendants merely offer the axiom, with which we do not disagree, that the district court, in determining whether to issue an injunction, should consider whether there is a likelihood of future violations of the securities laws. But, the question of whether there exists a reasonable likelihood of future violations simply cannot be asked and answered in a vacuum, without reference to the defendants' underlying conduct or the correct and controlling legal standards. 6/

Before it can conclude whether to exercise its discretion to grant an injunction, the district court must first determine whether, and under what

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6/ See SEC Br. 23:

> "The operative question on this appeal is whether the Commission is entitled to have the district court apply correct legal standards to the evidence presented in determining whether a violation of the federal securities laws has been proved, prior to determining whether the defendants are likely in the future to violate Section 10(b) and Rule 10b-5 and whether, in the exercise of its discretion, an injunction or other equitable relief should be issued."

circumstances, violations of the law occurred. Here, as already noted, the Commission alleged a course of selective disclosures of material inside information by the defendants. It cannot be gainsaid that the district court's erroneous views as to what constitutes a violation of the antifraud provisions of the federal securities laws, 7/ and its erroneous view of the standard of materiality applicable to those provisions, effectively colored its judgment in determining whether to grant injunctive relief. If, as we assert, the district court was not presented with an isolated instance of unlawful conduct, but rather, was presented with several unlawful selective disclosures, its findings of fact are not entitled to weight, 8/ and its exercise of discretion not to grant injunctive relief should be vacated and either remanded or reversed by this Court.

Our position in this regard cannot be altered by the defendants' characterization of the Commission's position as a request for an "advisory opinion. That characterization falls of its own weight when viewed in the light of this Court's repeated holdings that a finding of past violations is "highly suggestive of the likelihood of future violation" and can serve as the predicate for drawing an inference of the reasonable likelihood of future violations. See, e.g., Securities

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7/ In this respect, both the court below and the defendants have sought sanctuary within the confines of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). However, we have demonstrated already that either Hochfelder does not apply to a Commission action for prophylactic relief, or, if, in some form, it does apply, the standard has been met by the facts of this case (SEC Br. 31-66).

8/ See 5A Moore's Federal Practice ¶ 52.03[2] at 2664 (2d ed. 1948) (footnotes omitted):

> "Findings of fact that are induced by an erroneous view of the law are not binding. Nor are findings that combine both fact and law, when there is error as to the law."

and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801, 807 (C.A. 2, 1975). 9/

Moreover, the Commission is entitled to a finding of violation where, as here, the facts unequivocally will sustain it. 10/ And, such a finding assumes

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9/ And see SEC Br. 23-24; see also, Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171, 180-181 n. 6 (C.A. 2, 1976).

The dictum in Ring v. Author's League of America, 186 F.2d 637 (C.A. 2, 1951), upon which the defendants seek to rely (BOL Br. 38-39), actually supports the Commission's position. In Ring, this Court stated that, when the United States or an agency seeks injunctive relief, "there must be some tangible probability that the wrong will be repeated to justify an injunction." 186 F.2d at 643 (emphasis supplied). But, in order to determine whether "the wrong will be repeated," there must be an initial determination that a wrong has previously occurred. Such reasoning, applied to the case at bar, leads to the inescapable conclusion that the Commission's efforts to demonstrate prior violations of Section 10(b) and Rule 10b-5 are proper and not, as the defendants would have this Court believe, an attempt to secure an advisory opinion.

10/ See United States v. Parke, Davis & Co., 365 U.S. 125 (1961).

Had the district court not taken the position that the Commission is not entitled to injunctive relief except under "extraordinary circumstances," it would have seen that a more than adequate predicate for the grant of such relief was established.

Thus, as noted in our opening brief, the defendants easily and expeditiously prepared and issued a press release on March 1, 1972, releasing it almost silmultaneously to Dow Jones and Reuters, under far more trying conditions than the release they failed to issue on March 16, 1972. Indeed, the defendants omit from their description of the events of the afternoon of March 16, 1972, any mention of the facts that Gary Burkhead, an analyst from Smith Barney & Co., spent the entire afternoon in Mr. Schuman's office and overheard all of Mr. Schuman's telephone conversations in which BOL's earnings estimate was selectively disseminated to several favored individuals. In the light of the information that he had heard Mr. Schuman pass on to other individuals that afternoon (also including the disclosures concerning flattening sales and delays in the introduction of new products (JA 666)),

(footnote continued)

an even greater significance where, as in the instant action, the Commission is seeking equitable relief in the form of written procedures designed to assure future compliance with the law. Indeed, the finding of a violation of the federal securities laws can serve as the predicate for the imposition by a district court of equitable relief even in the absence of the issuance of an injunction. 11/

II. A PROHIBITION ON THE SELECTIVE DISCLOSURE OF MATERIAL, NONPUBLIC INSIDE INFORMATION WOULD NOT FORECLOSE ALL DISCUSSIONS BETWEEN CORPORATE MANAGEMENT AND SECURITIES ANALYSTS.

The facts of this case are simple. They undeniably portray a corporation and its Chief Executive Officer who selectively disseminated material, nonpublic inside information about BOL to a few favored analysts,

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10/ (Continued footnote)

Burkhead suggested that BOL and Mr. Schuman issue a press release (SEC Br. 13-16). But, as has been noted previously, only after substantial prodding by the New York Stock Exchange was that release forthcoming on the next day, March 17, 1972.

In this context, we are most disturbed by the defendants' refutation of an argument we did not make. They assert (BOL Br. 14 n.1) that the Commission attributed BOL's press release of March 1 to prodding by the New York Stock Exchange ("NYSE"). We did not. We attributed BOL's ultimate press release of March 17, after much delay, to prodding by the NYSE, a fact BOL does not, and could not, refute.

11/ See Securities and Exchange Commission v. Parklane Hosiery Co., Inc., Nos. 77-6012 and 77-6023 (C.A. 2, July 8, 1977); Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 395 (C.A. 2), certiorari denied, 414 U.S. 910 (1973); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 312 F. Supp. 77, 90-99 (S.D. N.Y., 1970), modified, 446 F.2d 1301, 1308 (C.A. 2), certiorari denied, 404 U.S. 1005 (1971); Securities and Exchange Commission v. Penn Central Co. [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶95,867 (E.D. Pa., 1976). See also, United States v. Moore, 340 U.S. 616 (1951). In Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1103 (1972), this Court stated:

> "It is now well established that Section 22(a) of the Securities Act of 1933 * * * and Section 27 of the 1934 Act * * * confer general equity powers upon the district courts * * *. Once the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy." (citations omitted.)

while the public traded in ignorance of those facts. The defendants seek to divert attention away from their unlawful conduct by urging that the Commission has embraced a policy that will serve to prohibit all discussions between corporate management and securities analysts (BOL Br. A-8).

In this regard, the defendants' efforts at hyperbole are the same as those that were attempted in the wake of this Court's landmark decision in the Texas Gulf Sulphur case 12/ -- that all communications between business and securities analysts would cease. 13/ Those overstatements did not come to pass, and we respectfully suggest that the defendants' dire predictions here will not come to pass either. This Court's agreement with the Commission's analysis would simply champion the already well-established principle that it is improper to disclose material inside information selectively.

The Commission has recognized "that discussions between corporate management and group analysts which provide a forum for filling interstices in analysis, for forming a direct impression of the quality of management, or for testing the meaning of public information, may be of value." Investors Management Co., Inc., 44 S.E.C. 633, 646 (1971) (footnote omitted). At the same time, the Commission has warned against the selective disclosure of material inside information. See, e.g., id. at 644. Whatever desirability there may be to have more definitive guidelines in this area (JA 149, 175; BOL Br. 8, 57) to govern activity close to the

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12/ Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833 (C.A. 2, 1968) (en banc), certiorari denied sub nom. Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969).

13/ See, e.g., Court Draws the Line on Insiders, Business Week, August 24, 1968, at 34-36; Editorial: Big Brother Spank!, Financial World, August 28, 1968, at 12.

line, this case does not present such a situation. The disclosures here constituted information of importance to reasonable investors (SEC Br. 66-83). Indeed, even the court below realized that the permissible range of communications between analysts and corporate management extends only to discussions involving information "which would not be significant to the ordinary investor" (JA 149).

III. NONPUBLIC INSIDE INFORMATION IS MATERIAL IF IT WOULD BE CONSIDERED IMPORTANT BY A REASONABLE INVESTOR. THE FACT THAT DIFFERENT INVESTORS WOULD FIND THE INFORMATION IMPORTANT IN REACHING DIFFERENT INVESTMENT DECISIONS SUPPORTS A FINDING OF MATERIALITY.

The defendants have raised only three points in their answering brief with respect to the issue of materiality which appear to merit any further attention.

1. The defendants argue that the analyst-recipients of the material inside information selectively disclosed by Mr. Schuman "were well aware of the adverse publicity [concerning soft contact lenses] and assumed that Soflens sales were being hurt by it" (BOL Br. 18, emphasis supplied). But, as we have noted, Mr. Schuman's disclosures concerning slipping sales and earnings were authoritative confirmations of what the analysts previously could only "assume" (SEC Br. 82). In addition to this confirmation, Mr. Schuman dealt the analysts an attractive bonus—the startling, and significant, revelation that important new Soflens products would not be sold, as expected, during the first quarter of BOL's fiscal year (SEC Br. 73-78).

2. In our opening brief, we pointed to the improper disclosure of earnings estimates during Mr. Schuman's interview with analysts Wien and Clancy (SEC Br. 72-73). Mr. Schuman advised them that a $3 earnings estimate would be too low, and that a $5 estimate would be too high. In response, the defendants suggest that the district court did not credit the Commission's evidence of those discussions (BOL Br.

19-20). However, there was no substantial conflict in the evidence for the district court to resolve. Indeed, the district court said nothing regarding such a conflict. Rather, it stated: "The evidence concerning the relevation of earnings estimates by Schuman during his talk with Wien and Clancy is not convincing; it cannot fairly be said that Schuman made statements which could be characterized as disclosures of earnings" (JA 153). Had Mr. Schuman stated to Messrs. Wien and Clancy that BOL's earnings would be approximately $4 per share, not even the lower court would have denied that such a statement was material (cf. JA 162-163). To draw a distinction between such a statement — of a $4 earnings estimate — and the statements actually made — that earnings would be more than $3 and less than $5 — would be to exalt form over substance. Materiality should not be required to depend upon the precise manner by which important information is conveyed, but, rather, should depend on the substance of the information actually divulged. 14/

3. Finally, the defendants argue that, although each of four analysts received "virtually identical" nonpublic, inside information from Mr. Schuman, each recommended a different investment decision along the buy-hold-sell spectrum (BOL Br. 26-27, A-7 - A-8). From this observation, the district court, as

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14/ The defendants also take pains to point out that the Commission's evidence on this point is contained in an "ex parte, hearsay transcript" of Clancy taken during the Commission's investigation (BOL Br. 19-20).

However, the defendants' brief fails to advise this Court that the defendants had stipulated, before trial, that, "[i]f called to the stand, * * * Clancy would give the testimony contained in the transcript excerpts of [his] testimony before the SEC * * *" (Stipulation Concerning Investigative Transcripts, dated March 26, 1976), and that the transcript was received into evidence, without objection, at trial (Trial Transcript pp. 7-8).

well as defendants, conclude that the information was not material (JA 159; BOL Br. 27).

But, the information disseminated by Mr. Schuman here was no less material merely because it was perceived differently by persons with different investment objectives. Rather than delve into a tangential investigation of the varying investment philosophies of individuals to account for necessarily varying investment decisions, the courts have concentrated on whether a reasonable investor would likely consider the information important in making a decision to buy, sell or hold a security. 15/ Materiality requires no more, and we do not assert that it means any less. Here, the information improperly disclosed by Mr. Schuman in fact was considered important by those receiving it and resulted in immediate investment decisions predicated upon that information. (Ex. 75-76, 78, 84; JA 94; JA 467-475, 477, 518; Ex. 211-212; JA 94).

Moreover, the district court's reference to the effect of the information on different recipients' respective investment conclusions ignores the most obvious workings of the securities markets. At any given time, under any state of available information, some investors may decide to buy, some may decide to sell, and some may decide to hold, a given security. Consequently, to observe that certain investors have made different investment decisions, on the basis of the same

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15/ See, e.g., TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

information, is merely to observe the securities markets in operation. 16/ The operative question is not what decisions investors reach in response to the nonpublic information involved, but whether the information would be considered important in making an investment decision. The events in this case amply satisfy that standard.

CONCLUSION

An essential purpose of the Congress in adopting the Securities Exchange Act in 1934 was the prevention of the misuse of material, nonpublic, corporate information. In this case, there is no question that, and the district court so found, the defendants disseminated material, nonpublic, information about BOL to a few favored individuals. Over the last 43 years, and particularly since this Court's decision in the Texas Gulf Sulphur case, the Commission's capacity to police the securities markets and to prevent abuses of the kind that occurred here has been enhanced by judicial interpretations of the Commission's authority and organic statutes.

Irrespective of whatever principle may govern private damage actions under the federal securities laws, the decision below, by requiring the Commission

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16/ Akin to this argument, the defendants state further that "[i]t ill behooves the Commission, which both here and below has argued that materiality should be inferred from the conduct of the analysts who met with Mr. Schuman, to claim that the district court committed reversible error by considering the analysts' reactions to the information discussed with Mr. Schuman in judging its materiality" (BOL Br. 46).

The term "reactions," as used by the defendants here, inappropriately dignifies the simple self-serving testimony by which the recipients of the information pronounced it to be immaterial. As we noted in our opening brief (SEC Br. 77), such evidence does not advance an analysis of the objective standard of the reasonable investor. On the other hand, a sudden trading turnabout closely following the receipt of non-public information, as occurred here, supports the inference that such information would likely be considered important by the reasonable investor in making a decision to buy, sell or hold a security (SEC Br. 80-83).

to prove the defendants' motivation for their improper use of privileged corporate information, would deal a serious setback to the Commission's ability to fulfill its important statutory mandate to maintain this Nation's capital market as the fairest and most effective in the world. The deleterious effect on the fairness and honesty of the nation's securities markets that flows from the misuse of inside information occurs irrespective of the motivation of the persons who so abuse their corporate trust.

* * * *

For the foregoing reasons, and for the reasons set forth in our opening brief, the Commission respectfully requests this Court to reverse the judgment of the district court and to remand this action to that court with instructions to consider whether, under proper legal standards, to exercise its discretion to issue an injunction and to direct BOL to formulate and implement appropriate written procedures to avoid a recurrence of the unlawful activities that occurred here. Alternatively, on the basis of the record made below, this Court should direct the district court to grant the relief requested by the Commission.

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July, 1977

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OFFICE OF THE
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July 27, 1977

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Re: Securities and Exchange Commission v. Bausch & Lomb Incorporated and Daniel G. Schuman, No. 76-6189

Dear Mr. Fusaro:

Enclosed for filing in the above-captioned action are ten copies of the reply brief of the Securities and Exchange Commission.

I hereby certify that I have today caused copies of the Commission's reply brief to be mailed, postage prepaid, to counsel for the appellees as follows:

Paul, Weiss, Rifkind, Wharton & Garrison
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Sincerely,

Edward B. Horahan III

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Attorney

Enclosures